IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR AMICUS CURIAE CHAMBER OF COMMERCE OF THE UNITED STATES IN SUPPORT OF PETITION

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STATEMENT OF INTEREST

The Chamber of Commerce of the United States ("the Chamber") is a nonprofit corporation organized and existing under the laws of the District of Columbia. The Chamber is the largest business federation in the United States. Its membership consists of over 67,000 businesses, the great majority of which are corporations, and more than 3,700 state and local chambers of commerce and trade associations, which in turn have numerous corporate members. Many of these corporations are engaged in the manufacture or distribution of goods for which an inventory of replacement parts is an essential business practice.

The *Thor* case raises, for the business and accounting communities, the important issue of the effect to be accorded generally accepted accounting principles in the valuation of inventories, under a statutory scheme requiring a method which embodies both the best accounting practice and the clear reflection of income. Because inventory valuation is invariably an accounting function and a sensitive element in the equation for deriving tax liability, unresolved questions presented here concerning the influence and significance of accepted accounting principles in federal taxation are a matter of compelling consequence. The decision reached below, affirming the disallowance of an accepted and rational formula for valuing inventory of replacement parts, has profound implications upon commerce, including such industries as automobile, appliance, industrial machinery and the like. Indeed, the issues here strike virtually every business maintaining a quantity of various replacement parts for the products it manufactures or distributes, whether toasters or nuclear generators. Moreover, as the Brief of the National Association of Manufacturers *Amicus Curiae* makes abundantly clear, the impact on litigation incident to enforcement of the revenue laws in issue has been substantial.

Coupled with substantial policy and practical considerations dictating review by this Court, there are significant issues relating to the statutory interpretation of Section 471 of the Internal Revenue Code and inherent inconsistencies between four Circuit Courts of Appeal. The Seventh Circuit reached an erroneous result in regard to each issue and, indeed, misconstrued the applicable regulations themselves. Any one of these elements would warrant review. Cumulatively they command it.

REASONS FOR GRANTING THE WRIT

1. This Court Should Resolve the Chronic Issue of the Relation Between Accepted Accounting Principles and the Clear Reflection of Taxable Income.

The most significant issue presented by this case is whether and to what extent a business taxpayer may rely upon sound and accepted commercial accounting standards to report taxable income, a problem that increasingly confronts every business. Resolution of that issue turns on the questionable premise of the decision below that, with no statutory or regulatory basis, recognized commercial accounting principles may be swept aside solely because of some obscure dissimilarity with tax accounting.

It is vital to businesses of every size and type that their financial results be accurately reported. The precise calibration of income, in particular, is an essential ingredient of major decision-making and is indispensable in assessing the health of a business. Rules of accounting have evolved with the singular objective of furnishing a stable and uniform gauge upon which business depends for internal and comparative judgments. Nevertheless, and despite a statutory commitment to accounting principles applicable here, the Seventh Circuit displaced a valid accounting principle because it differed in some undefined fashion from tax accounting. As the result, a business taxpayer is left at sea to rely upon an income measured by accepted accounting principles which may be freely undone by the Commissioner solely because of a supposed but unarticulated distinction between commercial and tax accounting. The revenue laws are too influential a factor in our economy to admit of such a standardless administration.

Contrary to the view expressed by the Seventh Circuit (A. 39-40),[1] commercial accounting cannot be considered alien to the Internal Revenue Code, especially in this context. In Section

1. "A" references are to the Appendix to taxpayer's petition filed herein, in which the opinion of the Seventh Circuit is reprinted.

446,[2] Congress adopted the general proposition that a taxpayer's method of accounting shall control the tax determination so long as income is not distorted. With respect to inventories specifically, the Code directs the Commissioner to prescribe only those valuation methods which conform "as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." I. R. C. § 471. As is demonstrated in Point 4, *Infra*, the method of inventory valuation utilized by the taxpayer here represented a realistic formulation of market value authorized by the relevant statute and its regulation. Yet, notwithstanding the fact that the governing statute confers equal status on commercial accounting principles and the clear reflection of income, the Seventh Circuit decision rejecting that valuation method is predicated on an asserted disparity between commercial and tax accounting. This produces genuine and disturbing confusion for the business taxpayer as to the relation between an accepted accounting principle and the clear reflection of income.

Resolution of that confusion requires analysis of the real distinctions between commercial and tax accounting, not the illusory ones. The antiquated and doctrinaire notion that commercial accounting principles may be readily discarded because they relate to conventional financial reporting is simply unrealistic. In the investment market, where the credibility of certified financial statements is acutely expected, there is signal emphasis upon the accuracy of annual earnings.[3] Despite the suspicion engendered by a difference which the Seventh Circuit could not or did not describe, it is unreasonable to deny that

2. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, 26 U. S. C. §§ 1 *et seq.* (1970). The relevant provisions are set forth in the Appendix to taxpayer's petition.

3. The accounting profession has repeatedly subscribed to the paramount interest in assuring that accounting principles render an accurate income statement. AICPA Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", ch. 2, ¶ 12 (1970); AICPA Accounting Research Bulletin No. 43, "Introduction", ¶ 3 (1953).

commercial and tax accounting share common objectives. It is equally arbitrary to dismiss accepted accounting principles simply on the shallow assertion of this undescribed difference. In the end, this claim of difference has become so entrenched that its mere assertion, according to the Commissioner, authorizes him to insulate his action from challenge. That assertion was accepted by the Seventh Circuit here.

Historically, a majority of this Court in two closely divided decisions, has rejected accepted accounting principles in the narrow area of prepaid income and required income to be reported in the year of receipt to prevent distortion of income. *Schlude* v. *Commissioner*, 372 U. S. 128 (1963); *American Automobile Ass'n.* v. *United States*, 367 U. S. 687 (1961).[4] On the other hand, principles for the obverse issue of liabilities incurred with the creation of income have been sanctioned, despite the Commissioner's repeated insistence that it distorts income. *Gillis* v. *United States*, 402 F. 2d 501 (5th Cir. 1968); *Denise Coal Co.* v. *Commissioner*, 271 F. 2d 930, 934-937 (3rd Cir. 1959); *Pacific Grape Products Co.* v. *Commissioner*, 219 F. 2d 862 (9th Cir. 1935). There is, in short, a decisive conflict in the permissible treatment of current income and current expenses. The identical accounting theory permitted

4. The majority opinion of Justice Clark was joined by Chief Justice Warren and Justices Black, Brennan, and White. The dissenting opinion of Justice Stewart was joined by Justices Douglas, Harlan and Goldberg. In the dissenting opinion of Justice Stewart, the following statement respecting the statutory predecessor of Section 446—a view which the majority opinion did not expressly repudiate—cogently describes the critical issue in this case:

> I think the Government's position in this case is at odds with the statutes, regulations, and court decisions, which, since 1916, have recognized that realistic accrual accounting does "clearly reflect income." If I am correct, the law did not give the Commissioner any "discretion . . . not to accept the taxpayer's accounting system."

367 U. S. at 711-712 (footnotes omitted).

The same voting alignment also occurred in *Schlude* v. *Commissioner*, 372 U. S. 128 (1963).

over the Commissioner's persistent objection for current expenses is not sanctioned for current income.[5]

In light of this chronic problem, the Court should take this case in order to pronounce substantive and procedural guidance for the frequent administrative dictate that an accepted accounting principle give way to the Commissioner's notion of what clearly reflects income. In this regard, there should be at least an obligation upon the Commissioner to justify his preference when it contradicts an accounting methodology widely regarded as designed to accurately report income. To the extent that resolution of this issue involves a re-examination of the implications of *American Automobile Association* and *Schlude*, it is respectfully suggested that there continues to be a serious need to bridge the difference between commercial and tax accounting with intelligible principles upon which business taxpayers can rely.

2. The Commissioner's Disallowance Violates the Substantive and Procedural Intent of the Statute Which Compels a Valuation Method Consistent with Accepted Accounting Practices.

A related but independent reason for this Court's review is that the Commissioner, in disallowing the taxpayer's accounting method which incontestably conformed to sound and generally accepted accounting principles, and the Seventh Circuit in approving his action, violated the intent of the statute and appropriate administrative procedure. Section 471 imposes an obligation on the Commissioner to prescribe a method of accounting conforming as nearly as possible to the "best accounting practice" and which "clearly reflects income." The Commissioner has long

5. Although this case relates to inventories and not current expenses, the pervasive accounting principle of matching period costs with revenues is very much at stake. The cost of making excess replacement parts and of their decline in value, should be recognized in the periods these facts occur or when income is received for the integral products with which they are associated, not some future artificial date.

been urged by interested parties to promulgate a regulation specifically governing the recurring problem of excess inventory. *See Patton, Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, N. Y. U. 23rd Inst. Fed. Tax. 839, 850 (1965). To the extent that existing regulations fail to do so, it is untenable that the Commissioner may take advantage of his failure and, simply by asserting that it distorts income, reject a method which clearly conforms to sound accounting principles.

The Chamber acknowledges that, to afford an orderly and efficient administration of the revenue laws, Congress has generally granted the Commissioner broad latitude in making determinations in varied contexts, and that such determinations are accorded a presumptive validity. *See, e.g., Helvering* v. *Taylor*, 293 U. S. 507 (1935); *Phillips* v. *Commissioner*, 283 U. S. 589 (1931). Here, however, Section 471 explicitly mandates two concrete standards in the determination—the best accounting practice and the clear reflection of income. In rejecting the taxpayer's method of accounting for inventory, the Commissioner's decision squarely contradicts the standard of best accounting practice.[6] But in doing so, the Commissioner did not necessarily promote the equivalent standard of clearly reflecting income, for there is nothing in this record to substantiate the claim that the accounting principle here distorts income. Moreover, the statute does not exalt one standard over the other but requires a method which, to the extent possible, most nearly satisfies both. Where, as here, the taxpayer's method indisputably satisfies one standard and arguably both, the Commissioner should not be permitted to overreach his discretion by a disallowance which fails to heed the statutory commands. The Commissioner's decision in this case which the Seventh Circuit approved, is indicative more of a reflexive action to

6. The Fifth Circuit in *Space Controls, Inc.* v. *Commissioner*, 322 F. 2d 144, 151 (5th Cir. 1963) (discussed *infra*, at pp. 10-13), correctly held that the best accounting practice is, by statute and regulations, equivalent to generally accepted accounting principles.

protect revenue than a reasoned and principled analysis of the issue.

Although Section 471 has a sparse legislative history, that which there is emphasizes the weight to be accorded the best accounting practice. The phrase "best accounting practice," first appeared in the Revenue Act of 1918, ch. 18, 43 Stat. 1057, 1060 and was inserted by a Senate amendment to the House Bill without significant discussion. When the provision was re-enacted in the Revenue Act of 1921, ch. 136, 42 Stat. 227, 231, however, Senate debate explicitly focused on the meaning of the language. In an exchange of views on the floor, set foth below,[7]

7. Senate consideration of the House Bill was moved by its floor leader, Senator Penrose, who was a member of the Senate Committee on Finance. S. R. No. 275, 67 Cong., 1st Sess. 1 (1921); 61 CONG. REC. (Part 6) 5788 (1921). Senator Penrose responded to an inquiry on the Senate floor as follows:

> MR. KING: Mr. President, may I inquire of the committee . . . whether it is the purpose of this amendment to authorize the commissioner to determine the form of inventory which shall be followed by all business houses in the United States that would be subject to these provisions, regardless of the efficiency and honesty of the methods pursued by business houses in carrying their inventories and ascertaining their liabilities, assets, and so forth?
>
> MR. PENROSE: Mr. President, the provision is existing law, without any alteration, and is now being administered without any great complaint having been called to my attention. *Where the books of a concern are accurate and kept in a businesslike way I am informed that they are accepted by the Treasury Department without question.*
>
> * * * * *
>
> MR. PENROSE: *The law says that the best accounting practice in the trade or business is to be followed. That is all that is necessary.* There is no trouble about this.
>
> MR. KING: Let me say to the Senator that there have been some complaints.
>
> MR. PENROSE: There may be.
>
> MR. KING: Not many have been brought to my attention, but some, that arbitrary requirements have been made by the department with respect to the form of inventories. Certain businesses have established a method of inventorying their business which have met their requirements, and which are regarded

(Footnote continued on next page.)

Congress declared a clear preference for accepted accounting standards as determinative except in instances of patent abuse. In light of the substantial progress in accounting principles since those days, it is captious to dismiss them upon the unelaborated[8] belief that they fail to clearly reflect income.

Without ascribing any definition to the element of clearly reflecting income, the Seventh Circuit nevertheless held that it was a question of fact subject to the clearly erroneous rule and that the Commissioner's "wide discretion" was not to be disturbed unless shown to be arbitrary. (A. 45-46.) That result under Section 471 is unprecedented, however, where the application of that "wide discretion" trammels the statutory element of the best accounting practice without a clue as to how income is thus clearly reflected. Even if the arbitrary standard were applicable to this case, as a matter of law it is nothing less than

(Footnote continued from preceding page.)

> by them and by others as being fair and honest, and a true reflection of the condition of the business; and it has been felt by some that to abandon accepted standards of business, adopted by business men, to conform to the whims and caprices —and I do not use those terms at all offensively—of officials works a very serious hardship.
>
> MR. PENROSE: Mr. President, if the Senator will pardon the expression, let me take absolute issue with him on that point. *The department does not make any arbitrary rules of accounting. The law compels the Internal Revenue Department to compel the taxpayer to follow the best accounting practice. They do not put their arbitrary methods in force. . . .*

61 CONG. REC. (Part 6) 5809 (1921) (emphasis added).

8. The Seventh Circuit here noted that the Tax Court's decision to set aside accepted accounting standards for failing to clearly reflect income was "without elaboration". (A. 41.) Further, the Court of Appeals acknowledged that the regulations, in stating that generally accepted accounting principles will ordinarily reflect income, implies that a method adhering to accounting standards presumptively satisfies the requirement of clearly reflecting income. (A. 44-45.) Yet, the Court of Appeals ruled that because the taxpayer under new management first acted upon the severe problem of excess inventory, its writedown was disqualified as not consistent with the practice of prior management. *Id.* This anomalous reasoning requires a taxpayer to perpetuate past error, even though violating accepted accounting principles with a resultant distortion of its financial picture.

arbitrary to renounce an accepted accounting principle dedicated to financial accuracy, which is all that the statute reasonably demands.

Hence, there exists a serious conflict between the Commissioner's powers as interpreted by the Seventh Circuit and the legislative import of Section 471. In this setting, substantive and procedural standards should be articulated by this Court to assure that the ultimate tax determination follows the mandate of the statute. Where, as here, the taxpayer presents uncontroverted evidence that its method conforms to the best accounting practice, there should be a duty upon the Commissioner to show that the method in fact distorts income or that an alternative method would more nearly adhere to both statutory elements.

3. The Decision of the Court of Appeals Is Inherently Inconsistent with Decisions of the Fifth, Sixth and Tenth Circuits.

Market value tailored to reality has historically been a cardinal tradition for valuation of inventories in our tax framework. *See United States Cartridge Co.* v. *United States,* 284 U. S. 511 (1932). In conflict with decisions in other circuits, the wooden interpretation of the relevant regulations by the Seventh Circuit here gave no credit to the discernible marketplace.

The Fifth and Sixth Circuits have applied the fundamental concept of market value in contexts equivalent to the situation here, where the net realizable value of goods was determined by a realistic appraisal of market conditions. The basic departure of the Seventh Circuit from a practicable application of market value is manifest in contrast with the decision in *Space Controls, Inc.* v. *Commissioner,* 322 F. 2d 144 (5th Cir. 1963). In that case, taxpayer sought to write down inventories of finished goods and work-in-process for custom trailers to the contract sales price which was substantially below cost. The Fifth Circuit rejected the Commissioner's contrary approach

which construed the regulations in a manner that ignored the practical realities of that marketplace. Interpreting a particular example of market value in the regulation, the Fifth Circuit enunciated the following principles which unmistakably conflict with the result reached by the Seventh Circuit:

> To approach it as did the Tax Court, reality would be exchanged for fiction. As to raw materials on hand . . . it reasoned, for example, that there was no evidence that the purchase price on the inventory date for each of the undescribed nuts, bolts, screws, rods, wheels, etc. was less than what had been paid, i.e., the cost. Consequently, it concluded, no comparative was established. But as an economic proposition, it is positively clear that to this Taxpayer such materials if then purchased would not have the value of their cost. Taxpayer's need was confined solely to this specific Government contract. It was obliged to fill that contract. It lacked the freedom which other "purchasers" of such items would have—namely, the right either to recall the items at a markup or use them in a profitable product. Legally bound as it was under its contract, Taxpayer was putting out a dollar to procure an item for which it would get approximately, 70¢. *With its stock on hand dedicated to a contract from which it could not legally escape, it would hardly be a true reflection of the financial condition of that concern were its inventory of dedicated goods valued at an amount which it could never get.* Good accounting practice, good business judgment, and administration of taxes all coincide to demonstrate the wisdom and applicability of . . . [the regulation].

322 F. 2d at 154 (emphasis added).

The same realistic approach to market value was endorsed by the Sixth Circuit in *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N. D. Ohio 1963), *aff'd,* 351 F. 2d 449 (6th Cir. 1965).[9] Although the taxpayers in those cases relied upon other

9. The District Court stated:

> The tax law and generally accepted principles of accounting recognize that substantial accuracy is the objective to be achieved and that in many situations exact determinations are neither practicable nor necessary. Huntington Securities Corporation v. Busey, 112 F. 2d 368 (6th Cir. 1940).

224 F. Supp. at 377.

examples of market values in the regulations, the overriding characteristic of both decisions is the acceptance by those Courts of Appeal of the realities of the market. In contrast, the Seventh Circuit decision is marked by a stringent construction of regulations erroneously regarded as the universe of the market value concept, which denies any space for this taxpayer's method despite its adherence to economic fact.

Each of the reasons espoused by the Seventh Circuit for upholding the Commissioner inflicts great damage to the concept of market value embodied in the regulations and expanded by the policies set forth in the *Space Controls* decision. First, that the facts here do not perfectly mesh with every detail of one or another regulation assumes a rigid construction eschewed by the Fifth Circuit in *Space Controls*.[10] What matters is an accurate assessment of market realities, not inflexible attachment to generalized rules. Second, because the same goods were classified between salable and unsalable, the Seventh Circuit found it impermissible to value differently fungible goods. But that is precisely what the Fifth Circuit found reasonable in *Space Controls*. The constituent nuts and bolts for the custom trailers were not valued according to what the same items would in theory bring on the market, but rather according to the ultimate disposition of those particular units. For separate reasons but with the same economic consequence, the taxpayer here could no more disgorge the excess parts on the market than the taxpayer could the nuts and bolts in *Space Controls*.[11] Finally, the Seventh

10. In addressing one provision of the inventory regulations, the court in *Space Controls* declared:

> The very nature of goods in process and the unidentifiable elements of cost, labor, burden, etc. make it impossible to apply literally § 1.471-4(c). We have recognized that this must be given practical application. S. G. Sample Co. v. Commissioner, 5 Cir. 1928, 23 F.2d 671 cited in 2 Mertens, Federal Income Taxation, § 16.21, n. 67, p. 46 (1961).

322 F. 2d at 154, n. 22

11. Further, the use of formulations tied to experience in computing taxable income is not unique to excess inventories. For

(Footnote continued on next page.)

Circuit imposed the harsh barrier of a closed transaction which conditions the writedown upon the physical disposition as scrap. Again, practical considerations are sacrificed to generalized rules. Moreover, the Fifth Circuit in *Space Controls,* relying upon a Tax Court decision, held that a trip to the junkyard was not a prerequisite to realizing scrap value:

> "When it became apparent that the going market value of a particular machine was less than (taxpayer's) cost basis, the inventory valuation was reduced to accord with market. . . . This procedure properly resulted in the realization of a loss when it occurred—the year the machine became worthless, not necessarily the year the machine was physically cast upon the scrap pile. C-O-Two Fire Equipment Co. v. Commissioner, 3 Cir., 1955, 219 F.2d 57."

Space Controls, Inc. v. *Commissioner,* 322 F. 2d at 152-153, *quoting from Ernest, Holedman & Collett, Inc.*, 1960 Tax Ct. Mem. Dec. (P-H) ¶ 60,010 at p. 54, *aff'd,* 290 F. 2d 3 (7th Cir. 1961).

The inflexible approach of the Seventh Circuit is also at odds with the recent decision of the Tenth Circuit in *Monfort of Colorado, Inc.* v. *United States,* 561 F. 2d 190 (10th Cir. 1977), where a taxpayer was allowed to include gains and losses from commodity hedging as an inventory cost. In contrast to the reasoning of the Seventh Circuit here, the Tenth Circuit ruled that taxpayer's method was "in keeping with the regulatory mandates that valuations of inventory must necessarily be flexible in order to give effect to trade customs . . ." 561 F. 2d at 196. More important, the Court also found it decisive that the regula-

(Footnote continued from preceding page.)

example, in arriving at the portion of account receivables representing bad debts, a business uses gross categories of aging as a reasonable estimate. It would be absurd to conclude that there are no worthless accounts in a group of "fungible" receivables simply because a taxpayer cannot select this or that particular receivable which will in fact default. Yet the burden of selecting, from multiple quantities of over 44,000 different replacement parts, those that were in fact worthless was unreasonably imposed upon the taxpayer in this case.

tions did not *prohibit* the method, rather than hanging the issue on what the regulations permitted:

> We deem it significant to note that the IRS expert acknowledged that there was nothing in the regulations, to the best of his knowledge, which prohibited Monfort's tax treatment of hedging gains/losses. Under the circumstances, we will not hold that there is but one way and one way only for Monfort to value its ending inventories.

Id.

In essence the decision of the Seventh Circuit is based on a slavish and unrealistic construction of the statute and regulations which distorts both the concept of market value and, consequently, taxable income. That approach collides with the policy of a practical, sensible analysis fostered by the Fifth, Sixth and Tenth Circuits which strives for reality, not fiction. Because this issue has widespread implications to the business economy and to the revenue laws, this Court should reconcile this palpable disparity which, left unresolved, promises to be a source of continuing confusion.

4. The Procedure Utilized by Taxpayer Was a Realistic Application of Market Value Authorized by Applicable Regulations.

The inventory regulations promulgated by the Commissioner explicitly approve the accepted accounting rule of lower of cost or market. Treas Reg. § 1.471-2(c) (1958). They also define examples of unusual market conditions which necessitate unique valuation procedures. The taxpayer here relied upon two separate definitions of exceptional market conditions to measure its inventory value. First, where no open market exists, a taxpayer is permitted to "use such evidence of a fair market price . . . as may be available." Treas. Reg. § 1.471-4(b) (1958). Second, in a comparable situation, yet another regulation accommodates market determinations for goods "unsalable at normal prices" in the case of such factors as "changes of style,

odd or broken lots or other similar causes." Treas. Reg. § 1.471-2(c) (1958). The Tax Court made findings which essentially equated these excessive replacement parts to "unsalable goods" and to goods for which an open market was lacking.[12] Nonetheless both the Tax Court and ultimately the Seventh Circuit held both regulations inapplicable by construing them impracticably and erroneously. More important, in concentrating upon minutiae in the regulations, the decision of the Seventh Circuit completely lost sight of the fact that taxpayer's method was a rational and empirical appraisal of market realities, the very objective both regulations encourage.

In providing for the lack of an open market, Regulation § 1.471-4(b) recognizes that supply and demand are prominent in the market value equation. If the quantity is too large to be absorbed by the available market, even with demand stimulated by price reductions, there is no "open" market. By definition, there simply was no market for the portion of the inventory here reasonably concluded upon past experience to be unsalable in any event. It was precisely for this reason that the taxpayer

12. The Tax Court found that:

> [E]xcess parts . . . comprised in each year from 70 percent to 82 percent of the excess inventory costs. *The market for such parts was confined to owners of the related tools who purchased replacement parts when and if needed and would not buy parts not needed merely because of price reductions.*
>
> Petitioner reduced prices on some finished tools where management believed that price reductions would stimulate sufficient additional sales to increase its gross income. Most of the finished tools in excess supply, however, were specialized products, and petitioner's management concluded that *their potential market was so limited that a price reduction would not stimulate additional sales to increase gross receipts above what they would be if the salable quantities were sold at current prices. . . .*
>
> Petitioner's management concluded that *the only secondary market for excess work-in-process* (consisting of partially completed parts or tools) *was as scrap. Petitioner attempted to sell excess raw materials in 1964, but these efforts met with very little success because users of such hardware items as nuts, bolts, screws and washers, prefer to purchase them from an established supplier. . . .*
>
> (A. 14; emphasis added.)

was compelled to writedown the inventory for the purposes of financial accounting and securities regulation. In accordance with Regulation § 1.471-4(b), market value was thus computed with the best available evidence, management experience fortified by the unchallenged testimony of highly qualified professionals. In the face of this, the Commissioner introduced no evidence whatever.

The Seventh Circuit held Regulation § 1.471-4(b) inapplicable on the grounds that excess inventory is a common problem and therefore not an "extraordinary circumstance." This is an obvious misreading of the regulation. It and other regulations are concerned with the efficiency of the market conditions and the validity of the market price, not the frequency with which the problem occurs. The "normal conditions" referred to are such situations as an active market, arms length transactions, sufficient depth to absorb the quantity of goods involved, and responsiveness to the normal laws of supply and demand. Since these conditions were demonstrably absent here, there was no open market for the goods in the quantity involved. The regulations specifically recognize this lack of an open market as an untypical circumstance justifying special valuation procedures.

With respect to Regulation § 1.471-2(c), even though the inventory items were "unsalable at normal prices," the Seventh Circuit nevertheless held that excess inventory could not be equated to "changes of style, odd or broken lots, or other similar causes." In particular, it was held that the unsalability here was not attributable to any "other similar cause" since all enumerated causes consisted of defective goods distinct from the remaining inventory, while excess inventory was indistinguishable from the salable portion of the inventory.

This reasoning reflects a unreasonable construction of Regulation § 1.471-2(c) which conflicts with its overriding purpose. Two of the specified causes, "changes of style" and "odd or broken lots," in fact assign different values between physically

fungible goods in recognition of market dynamics. Odd lots may be valued lower, not because of a physical distinction, but in view of their unsuitability in the established market. Further, all the excess inventory was economically equivalent to an odd lot, inasmuch as it constituted an abnormal quantity unfit for market conditions.[13]

In short, the language of both regulations are readily adaptable to excess inventory, especially if read in light of their purpose of attaining a realistic application of market value.

CONCLUSION

The economic scope of the issues in this case is extraordinary both as to the extent of prospective litigation and the amount of income taxes involved. Equally at stake is the choice of a creditable policy that recognizes the validity of reliable accounting rules consistent with the statutory framework, in place of one that uncritically acquiesces in administrative action that bears no identifiable standards. It is within the distinctive province

13. Regulation § 1.471-2(c) states that with respect to the enumerated causes, the abnormality in the market is to be measured by an actual offering of the goods within 30 days after the inventory closing. Literal application of that requirement would serve no purpose here. The Tax Court found that taxpayer did offer goods at reduced prices when gross receipts would not decrease. Taxpayer cannot be made to suffer an additional loss simply to establish its loss in a prior year. *See C-O-Two Fire Equipment Co.* v. *Commissioner*, 219 F. 2d 57 (3d Cir. 1955).

of this Court to review the unsettling and unfair result in this case which adversely affects so many taxpayers.

For the foregoing reasons, this Court should grant the petition for writ of certiorari.

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